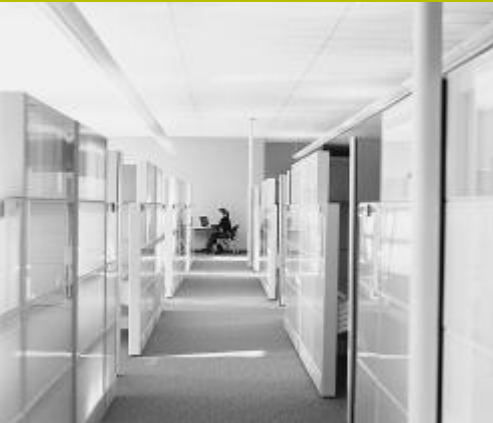




Rule 105 of Regulation M



Operational Risk
Breakfast Club
December 3, 2013

Daniel N. Marx

- What is Rule 105?
- How to comply with Rule 105?
- What is the SEC doing about Rule 105?

Rule 105 of Regulation M:

In connection with an offering of equity securities for cash pursuant to a registration statement or notification on Form 1-A or Form 1-E filed under the Securities Act of 1933, *it shall be unlawful for any person to sell short the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering* if such short sale was effected during the period (“*the Rule 105 period*”) that is the shorter of the period:

- (1) Beginning five business days before the pricing of the offered securities and ending with such pricing; or
- (2) Beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing.

17 C.F.R. § 242.105(a)

■ Assumptions

- Short sales depress prices
- Offerings typically price at discounts to the market

■ Rationales

- Benefit to the violator
- Detriment to the issuer
- Manipulation of the market

The Basics



*Participation in this offering **violates** Rule 105.*

The Five-Day Restricted Period

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
1	2 ? SHORT	3 X SHORT	4 X SHORT	5	6	7
8	9 PRICING	10	11	12	13	14

Rule 105 — Applicable to pre-Oct. 9, 2007 rule text

Q: If a person has a short position and makes short sales during the five business day period prior to the pricing of a distribution of that security, may it purchase shares in the distribution to cover securities sold short prior to the five day window?

A: No. In order to avoid the abuse at which Rule 105 is directed, a person cannot purchase securities in a distribution to cover any short position where it made short sales of the security during the five business days before pricing.



The Old Rule: No Covering

“Rule 105 is intended to prevent manipulative short selling prior to a public offering by short sellers who *cover their short positions* by purchasing securities in the offering.”

The New Rule: No Purchasing

“The amended [Rule 105] refines that approach. As proposed and as adopted, the amendment changes the prohibited activity from covering to *purchasing the offered security*, in order to put an end to strategies that obfuscated the prohibited covering but replicated its economic effect.”

Theory v. Practice

In Theory: Rule 105 is an anti-manipulation regulation.

“The amendments [to Rule 105] enhance market integrity by prohibiting *conduct that can be manipulative* around the time an offering is priced so that market prices can be fairly determined by an independent market. The amendments are designed to promote offering prices that are determined by the natural forces of supply and demand. We believe the amendments safeguard the integrity of the capital raising process and protect issuers from *potentially manipulative activity* that can reduce offering proceeds.”

In Practice: Rule 105 imposes strict liability, regardless of manipulative intent or effect.

“Rule 105 is prophylactic. Thus, its provisions apply *irrespective of a short seller's intent.*”

Three Exceptions

Bona Fide Purchases

- Quantity
- Reporting
- Timing

Separate Accounts

- Separate and distinct strategies and objectives
- No coordination between personnel
- No sharing of information between accounts
- Separate P&L statements for accounts
- No allocation among accounts

Investment Companies

“The Commission cautions that any transactions . . ., whether or not subject to the provisions of amended Rule 105, continue to be subject to the anti-fraud and anti-manipulation provisions of the federal securities laws.”

SEC Final Rule, “*Short Selling in Connection with a Public Offering*,” 72 Fed. Reg. 45094, 45096 n.46 (Aug. 10, 2007)

How to Comply with Rule 105?

“To be in compliance with Rule 105, a person that for any reason has sold short shares of a security that is the subject of an offering during the restricted period must generally either *refrain from purchasing shares* of that security in the offering, or *rely on an exception*.”

OCIE National Examination Program Risk Alert, “*Rule 105 of Regulation M: Short Selling in Connection with a Public Offering*” (Sept. 17, 2013)

- ✓ Draft Compliance Policy
- ✓ Implement Compliance Procedure
- ✓ Train Relevant Personnel
- ✓ Assign Responsibility for Compliance
- ✓ Regularly Review Compliance Policy and Procedure



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PRESS RELEASE



SEC Charges 23 Firms With Short Selling Violations in Crackdown on Potential Manipulation in Advance of Stock Offerings

FOR IMMEDIATE RELEASE 2013-182

Washington D.C., Sept. 17, 2013 — The Securities and Exchange Commission today announced enforcement actions against 23 firms for short selling violations as the agency increases its focus on preventing firms from improperly participating in public stock offerings after selling short those same stocks. Such violations typically result in illicit profits for the firms.

The enforcement actions are being settled by 22 of the 23 firms charged, resulting in more than \$14.4 million in monetary sanctions.

Related Materials

- [Risk Alert on Rule 105 Compliance](#)

The “Broken Windows” Philosophy



- SEC Chair Mary Jo White:

“We used [the SEC’s] new streamlined approach most recently when we brought actions against nearly two dozen firms for violating Rule 105 of Regulation M. . . In the process, we sent a message that *we will not tolerate any violations* – big or small – that threaten the integrity of the capital raising process. And we think that the message is being heard.”

– Remarks at the Securities Enforcement Forum (Oct. 9, 2013)

- Enforcement Division Co-Director Andrew Ceresney:

“The benchmark of an effective enforcement program is *zero tolerance for any securities law violations, including violations that do not require manipulative intent*. Through this new program of streamlined investigations and resolutions of Rule 105 violations, we are sending the clear message that firms must pay the price for violations while also conserving agency resources.”

– SEC Press Release (Sept. 17, 2013)

So Many Fish in the Rule 105 Barrel

Since January 2010 –

40+ Enforcement Actions

75% against Investment Advisers

\$42M+ in Disgorgement, Interest and Penalties

Enforcement Process

- Informal inquiry (referral from OCIE to Enforcement Division)
- Production of documents and trading information
- Interviews
- “Wells Lite” – Submission of “optional narrative”
- Settlement offer

Settlement Formula

- Cease-and-desist
- Censure
- Disgorgement and pre-judgment interest
- Civil monetary penalty

Other Issues

- Individual liability
- “Bad Boy” disqualification

How does the SEC calculate “ill-gotten gains”?

- “Short Profit”

= (Short Price – Offering Price) x Number of “Cover” Shares

- “Offering Profit”

= (VWAP – Offering Price) x Number of “Extra” Shares

- Example

ABC Fund shorted 10,000 shares of XYZ Corp. at \$20 per share.

ABC Fund bought 20,000 shares of XYZ Corp. in a secondary offering at \$10 per share.

The VWAP on the day of the offering was \$15 per share.

ABC Fund made a “short profit” of \$100,000 [\$10 per share x 10,000 cover shares]

ABC Fund also made an “offering profit” of \$50,000 [\$5 per share x 10,000 extra shares]

The SEC will demand disgorgement of \$150,000 plus interest.

What to Do if the SEC Calls?

- ✓ Contact outside counsel
- ✓ Preserve all potentially relevant records (including trading records, emails, etc.)
- ✓ Review all potential violations that the SEC identifies
- ✓ Search for any other potential violations (and consider making voluntary disclosures)
- ✓ Designate an appropriate individual to handle the matter (typically, the CCO or GC)

What to Do If You Find a Violation?

- Absolutely —
Remediate the
Rule 105 problem(s)
before the SEC calls
- Possibly —
Self-Report the
Rule 105 violations(s)
before the SEC calls

Questions?